

# Research Report

in Finance and Banking

## The Economics of the Proposed European Takeover Directive

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with  
Peer Ritter  
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CENTRE FOR  
EUROPEAN  
POLICY  
STUDIES

# **THE ECONOMICS OF THE PROPOSED EUROPEAN TAKEOVER DIRECTIVE**

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## **EXECUTIVE SUMMARY**

**A**widely held sentiment is that a coherent EU policy is needed for the regulation of takeover bids. In terms of policy aims, the Commission has been seeking for more than a decade to create the conditions for the development of an active cross-border market for corporate control. Progress towards a cross-border mergers and acquisitions market is hindered by the existence of 15 different national systems of takeover regulation and the retention of costly structural and technical barriers to takeovers. In fact, steps taken by the EU in 1996 to revive the plans for a regulatory framework for harmonising takeover law that would yield improvements for organisations and shareholders were undermined by certain member states opposed to a framework based on the British City Code on Takeovers and Mergers. Despite the failure in the European Parliament to pass the Thirteenth Directive in 2001, this did not alter the ambitions of EU policy-makers who recognise the importance of a cross-border takeover market for the evolution of capital markets and the efficient allocation of capital. In this context, the European Council held in Lisbon in March 2000, which established the objective for Europe to become the most competitive economy in the world, endorsed the re-introduction of a common framework for cross-border takeover bids. Ultimately, the passage of takeover legislation would serve to create the opportunities for firms to reposition themselves in the European market and signal that steps are being taken to foster liquid markets.

On 2 October 2002, the European Commission presented a new proposal for a Directive on takeover bids. Not surprisingly, the new draft relies on the basic principles of its predecessor. The new proposal has been improved significantly due the Commission's decision to incorporate some of the recommendations made by the Group of High-Level Company Law Experts. Notably, the new proposal provides a common definition of 'equitable price', and the introduction of squeeze-out and sell-out rights. In January 2003, the European Parliament published a working paper that recommends the application of the breakthrough provisions to multiple voting arrangements and a requirement that the bidder must pay 'fair compensation' to the holders of the shares broken through. In the meantime, MEPs, under the direction of the Committee on Legal Affairs and the Internal Market Rapporteur Klaus-Heiner Lehne, have proposed a number of amendments that would allow, inter alia, the application of the break-through rule to multiple voting arrangements, and permit member states to prohibit takeovers originating in third countries so long as EU bidders are hampered by poison pills and other obstacles to takeovers.

The proposed Directive is based on two key features – the mandatory bid rule and the prohibition against defensive measures initiated by the management board – which provide the model for the governing code on acquisitions. A third, major provision, found in Art. 11, prohibits any restrictions on the transfer of securities contained in articles of association and contractual arrangements during the period of acceptance of a bid. It is worth noting that the provision on pre-bid strategic embedded defences also covers legitimate arrangements that are ostensibly used by managers in a variety of situations besides the takeover context.

### **The report in a nutshell**

1. European policy-makers should agree on clearly defined objectives and principles of corporate governance that create substantial benefits for shareholders. This could lead to higher firm valuations and lower costs of capital for firms.
2. Takeovers are about increasing efficiency. Their function is to reallocate existing physical and financial assets. They involve the distribution of funds to shareholders. Furthermore, takeovers act as an incentive to managers to increase allocative efficiency of investment funds.
3. In the area of takeovers, there is evidence that capital markets have the capacity to discriminate between different takeover bids based on the degree of transparency and of shareholder rights protection. This report shows that lower premiums are offered when the shareholder rights index of the bidding shareholders is high. When the accounting standards of the target firm are high, a higher bid for the target is made. Consequently, bidding firms are willing to pay relatively higher premiums for companies with better transparency created by higher accounting standards. The report also shows that a bidding firm is willing to pay a higher premium when the principle of one-share/one-vote is upheld by the target firm – this means that there are no pyramids or multiple voting shares – a higher premium is offered for the target shares. The proposed Directive could help to make markets more transparent and improve the efficiency of the market.
4. The level playing field principle, which consists of the break-through rule and the board neutrality rule introduced by the High Level Group, remains vague and capable of causing conflicting interpretations. Each of the proposed measures in the takeover bids Directive should be analysed on its own merits.
5. The underlying economic claim for the level playing field is that differences in regulatory arrangements distort the conditions of competition. The fairness claims about the differences in laws and policies of non-EC nations are based solely on a distributive rather than allocative efficiency argument.
6. The level playing field for takeovers is not a suitable yardstick for takeover regulation. From a social welfare point of view, policy-makers should adopt policies that encourage value-creating bids and discourage value-decreasing bids. Any proposal that would result in a regime that screens out value-increasing takeovers – based on differences in regulation – cannot be defended on a procedural or substantive basis. Ultimately, of course, such a policy would result in lower efficiency gains overall which is contrary to aims of the legislation.

7. EU takeover regulation must attempt to locate an optimal balance between harmonisation and diversity. On the one hand, the benefit of the proposed Directive lies in the provision of simple common rules that avoid some of the cost and difficulties of complex rules of differing national regimes (e.g. board neutrality). On the other hand, it is far from clear that member states with different laws and traditions will be served by proposals of the European Parliament that mandate additional change at the national level (e.g. threshold level).
8. The mandatory bid rule is a sound device to prevent expropriation from minority shareholders. The mandatory bid also eliminates the two-tier discriminatory bid, which limits the pressure to tender problem. The Commission's equitable price proposal is simple and demanding on the bidder, ensuring that some value-increasing bids may fail. The report endorses the view that member states should be allowed to set the thresholds for mandatory bids. This policy is reasonable given the variations in national legal traditions across the EU.
9. There are good reasons to reject the break-through rule. At the level of theory, there is no question that it violates the principle of shareholder decision-making, which is used by the High Level Group to justify the principle of board neutrality. There is also a logical inconsistency between the break-through rule and the mandatory bid rule.
10. We do not see any immediate need to include a break-through rule in the directive. As long as the market is transparent, it will be able to price capital structures – and, if they are considered to be value-decreasing, raise the capital cost for the company concerned.
11. Assuming, however, that a break-through rule is adopted, the scope seems arbitrary if some deviations from the one-share/one-vote rule are included and others are not. Multiple voting shares have in principle the same economic effect as preferred shares or shares with restricted transferability or shares where the voting right is acquired after two years' holding.
12. Assuming that the break-through rule is adopted into legislation, it is submitted that bidders should compensate the holders of dual and multiple class shares that have been broken through. Requiring compensation to the holders of special voting rights will not frustrate the legislative aim of the Directive, *viz.*, the creation of a European market for corporate control.
13. The European Parliament Working Paper's recommendation to pay 'fair compensation' to the holders of shares that are broken through is unconvincing, not because compensation is unnecessary but because the proposed rule would actually reverse causality: the compensation rule would determine the premium. As a consequence, it is likely that the Directive could be challenged on the basis that compensation was inadequate.
14. To the extent that the break-through provisions affect acquired rights, the system by which compensation is calculated should be sufficiently flexible to take full account of the diverse circumstances of the deprived shareholders.
15. If a break-through rule was adopted, the report favours grandfathering the existing dual- and multiple-class shares for a substantial period of time. We believe that this

position has the advantage that compensation might not be necessary or, if so, at very low levels.

16. The report rejects the view that a sell-out right given to the holders of multiple voting rights based on a price presumption is a means for compensation. In practice, such a right is likely to have no effect.
17. The report supports the Commission's approach on board neutrality. The principal argument in favour of this approach is that it limits the potential coercive effect of a bid. Whilst there may be circumstances in which the target management has better information than the market, the proposed Directive allows for ample opportunity for the incumbent to reveal their business plans to shareholders. Takeovers are an opportunity where shareholders are given the opportunity to assess the performance of the incumbent management team compared with a rival.
18. Even though it would appear that some exceptions to board neutrality are justified (e.g., reserve authorisations), they would come at the cost of less transparency. Board neutrality should, moreover, be endorsed because it offers, in light of some national company law regimes, some degree of simplicity into the regulatory framework.
19. Under Art. 14 of the proposed Directive, a majority shareholder can exert a squeeze-out under the constraint that he holds between 90% and 95% of the capital following a full bid. In principle, the proposed squeeze-out rules are acceptable but they leave too much room for national peculiarities. In this regard, appraisal proceedings should be discouraged in favour of simpler methods
20. The proposed Directive should not be restricted to bidders from the EU. When bidders compete for a target, shareholders will benefit ultimately. To be sure, when the same rules apply to all bidders, it is less complicated for shareholders to make an informed decision about a bid. However, there should be no attempt to level the playing field with the US. Harmonisation claims that are based on fair competition (and would justify protectionism) would mean undertaking measures that cannot be justified from an efficiency point of view.
21. Since the aim of the proposed Directive is to encourage value-increasing takeovers, it matters little whether the bidder originates from the US or the EU. Thus, efforts to frustrate this end by adopting legislation that benefits a small group at the expense of most groups in the EU is certainly a strong argument against the Commission's attempt to harmonise EC takeover law.
22. Proposals to allow the national securities regulator to frustrate takeover bids if the bidder has some degree of market dominance in its home country should be rejected. This would imply that the securities regulatory authority would have to decide on issues of market dominance. To overload the takeover Directive with issues of market dominance would create conflicts between the competition authorities and securities regulator.

## **Policy recommendations**

To begin with, it is clear that the level playing field idea does not offer useful guidance in the policy debate. Claims based on the idea of the level playing field dominate the legislative history of the takeover bids Directive. Unfortunately, as pointed out by a number of experts, the concept has many different meanings. The demand for equivalent access has little normative support in the established rules and structures of the international economy.

As should already be apparent, the debate on the takeover Directive should focus on the efficiency implications of the proposed legislation. In this sense, competitive forces in European capital markets should be strengthened by improved transparency. It is also important to emphasise that corporate governance has a direct impact on corporate performance through market prices. Well governed bidders will find it easier to raise capital to finance an acquisition. This argument, of course, does not require the creation of a level playing field instituted by statute. Overall, there are gains to be achieved by creating an active cross-border takeover market that protects minority shareholders and promotes higher disclosure standards. A European takeover Directive should thus include provisions that improve transparency for bidders across the European Union.

Moreover, the proposed Directive should include:

- a mandatory bid rule requiring that a bidder must make an equitable offer to all shareholders;
- the ‘level of control’ should be left for the member states to determine;
- a simple rule that restricts target management intervention after the bid is made to simply expressing its own view about the proposed takeover bid; and
- a simple and efficient rule on squeeze-outs.

A break-through rule will not contribute to transparency and will complicate bids and raise legal costs. Consequently, we recommend rejecting the inclusion of a break-through rule in the proposed Directive.